SUPREME COURT, U. S.

278

Office-Supreme Court, U.S.
FILED
JUN 20 1967
JOHN F. DAVIS, CLERK

In the

Supreme Court of the United States

OCTOBER TERM, 1967

No. 22,173

J. GORDON TURNBULL, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

WENTWORTH T. DURANT,
3434 First National Bank Building,
Dallas, Texas,

RONALD M. MANKOFF,
3434 First National Bank Building,
Dallas, Texas,
Counsel for Petitioner.

WARLICK PRESS, INC.—P. O. BOX 10543—2263 VALDINA STREET—DALLAS—ME 1-3150

INDEX

	Page
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	4
Reasons for Granting the Writ	7
Conclusion	11
Appendix A—Statutes	A-1
Appendix B—Opinions, Judgments and Orders Below	B-1

Page

Cases

Chicago Stock Yard Co., Helvering v., 318 U.S. 693 (1943) 7

Eastern R. and Lumber Co., 12 T.C. 869 (1949) 9

Egan, Inc. v. Comm'r, 236 F. 2d 343 (8th Cir., 1956) 9

Hellmich v. Hellman, 276 U.S. 233 (1928) 5, 9

National Grocery Co., Helvering v., 304 U.S. 282 (1938) 7

Snyder v. Nathan, 353 F.2d 3 (7th Cir., 1965) 8

In the

Supreme Court of the United States

OCTOBER TERM, 1967

No. 22,173

J. GORDON TURNBULL, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above case on March 22, 1967.

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 622, Vol. III) is reported at 41 T.C. 358 and is reprinted at Appendix B-11. The opinion of the United States

Court of Appeals for the Fifth Circuit (R. 775-783, Vol. IV) is reported at 373 F. 2d 87 and is reprinted at page 1 in Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was made on February 1, 1967 (R. 794); Petition for Rehearing duly filed on February 21, 1967 (R. 796), was denied and judgment was entered on March 22, 1967 (R. 812). Mandate was issued on April 7, 1967 (R. 794, Vol. IV). Copies of the Judgment and Order are reprinted at Appendix B—9, 10. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the penalty against improperly accumulating earnings for the purpose of avoiding dividend taxation to its shareholders may properly be charged against a corporation actively engaged in the process of liquidating its business in anticipation of distributing all of its assets to shareholders. §102, I.R.C., 1939; §531, I.R.C., 1954.

2. Whether a corporation in liquidation may reasonably accumulate earnings to meet its obligations as a liquidating company, including wholly contingent future liabilities and current year's taxes without thereby subjecting itself to this penalty §102, I.R.C., 1939; §533, I.R.C., 1954.

STATUTES INVOLVED

Section 102, Internal Revenue Code of 1939, and Part I, Subchapter G, Internal Revenue Code of 1954, are set forth in Appendix A hereto.

STATEMENT

Petitioner was a corporation founded, owned and managed by Mr. J. Gordon Turnbull and engaged in the business of furnishing engineering services. On April 1, 1953, Mr. Turnbull died. Pursuant to instructions left by him, the corporation immediately undertook the liquidation of its business. All outstanding bids for new work were recalled; no new contracts were taken; and uncompleted projects in the Midwest were sold to the manager of its Kansas City branch office. Petitioner retained its key employees to complete these remaining contracts which were already in process.

In the next month, Petitioner's key employees approached its management and asked for the opportunity to buy the "shell" of the corporation after all of its outstanding stock had been redeemed. A Request for Ruling on the tax consequences to present shareholders if their stock was redeemed and the corporation continued business with new shareholders was made in July. Thereafter, Petitioner received offers from competitors who expressed interest in purchasing its stock. Each of these offers was withdrawn, however, when it was disclosed that Petitioner was a co-defendant named in lawsuits claiming $532,895 for injuries and a death following the collapse of a structure in South Texas. Petitioner's two insurers had disclaimed coverage because of late notice, although one had agreed to undertake Petitioner's defense. One of the potential stock buyers did offer to pay $100,000 extra to Mrs. Turnbull, heir to the corporation's stock, if she would personally indemnify the buyer against liability

on these lawsuits. She and her attorney, who were also Petitioner's remaining directors, refused this offer.

At the end of Petitioner's fiscal year, November 30, 1953, no response had been received to the Request for Ruling. A New York attorney was retained to assist in securing the ruling and he forwarded additional information in its support. No distributions to shareholders were made by Petitioner during the fiscal year ended November 30, 1953; dividends of $16,240 had been paid in the previous year and in each of the years ending November 30, 1950 and 1949. In 1948, $40,775 had been paid as dividends.

In December, 1953, H. R. Henderson & Co., a construction firm which had also been named as a co-defendant in the South Texas lawsuits, authorized an inquiry into the possibility of purchasing Petitioner's stock. In January, 1954, Henderson's directors authorized an offer to pay $975,000 for Petitioner's stock with no conditions concerning the lawsuits. This offer was accepted by Mrs. Turnbull and the Estate of J. Gordon Turnbull. During th e negotiations, the Commissioner did issue a Ruling that the redemption of Petitioner's stock would constitute a distribution in liquidation notwithstanding the sale of new stock to others and continuation of Petitioner's business. The Ruling stated that distributions to Petitioner's shareholders would have been taxable as capital gains. (R. 691).

Henderson purchased Petitioner's stock on February 5, 1954. In October of that year, and after the "miraculous

recovery" of the injured workmen, the South Texas lawsuits were settled by an insurance company's payment of $5,000 on Petitioner's behalf.

The Commissioner determined that Petitioner was liable for the penalty provided in §102, I.R.C., 1939, for the years ended November 30, 1952 and 1953 and the short period ending February 4, 1954. Petition to the Tax Court of the United States was duly filed.

Petitioner denied that it was liable for the penalty in 1953 and thereafter because, at that time, it was in a bona fide state of liquidation. Any distributions it might have made to its shareholders would, as a matter of law, have been liquidating dividends taxable as capital gains. *Hellmich v. Hellman*, 276 U.S. 233 (1928). Therefore, it could not have been involved in a scheme to avoid dividend income to its shareholders.

The Tax Court admitted this factual premise, but came to a contrary conclusion. It held,

> "During 1953 the petitioner was in the process of winding up it affairs, although no formal plan of liquidation had been adopted. The mere fact that a corporation is in the process of liquidation or winding up its affairs does not prevent the application of the tax on unreasonable accumulation of earnings. To the contrary, if a taxpayer's business has terminated or become inactive, usually there is no longer any reasonable business need for retaining accumulated earnings." (App. B-41)

Alternatively, and also with reference to its "reasonable business needs", Petitioner had argued that in 1953, its "business" had been converted to that of managing its own

liquidation. In that capacity, it was legally required to protect its solvency. Therefore, it was justified in accumulating assets, including current earnings, to meet all possible corporate liabilities, including contingent possibilities of future liability. This business necessity was claimed because no future years' income could be anticipated to meet such contingencies if they did come to fruition. In this particular case, the tort lawsuits filed against Petitioner, were claimed as justification for accumulations. Federal income taxes on 1953 earnings were claimed as offsets against undistributed income.

The Tax Court denied Petitioner's need to accumulate for these contingencies because (1) Petitioner wasn't actually liable on the tort suits which were ultimately settled at no direct cost to Petitioner and (2) the statute (§102(d)(1)(A)) did not allow a cash basis corporation to offset Federal income taxes for the current year against undistributed current earnings.

Petitioner was held to be liable for the penalty for all years at issue; however, the computation of the penalty showed that there were no undistributed net earnings upon which the penalty could be imposed for the years ended November 30, 1952, and February 4, 1954.

The Court of Appeals affirmed the Tax Court but changed from a legal to a factual ground. The Tax Court had admitted the fact of Petitioner's "process of liquidation" but denied its relevancy; the Court of Appeals held that because

Petitioner did not actually liquidate or pay liquidating dividends in 1953, it could not "properly contend that an orderly liquidation defeated the §102 tax." (App. B-8)

REASONS FOR GRANTING THE WRIT

The United States Court of Appeals for the Fifth Circuit has decided an important question of Federal tax law which has not but should be settled by this Court because of its continuing general application to corporations in liquidation.

A corporation which is "used" by its shareholders in a particular kind of scheme to avoid tax on its shareholders may be penalized for its complicity.

Section 531, I.R.C., 1954, and, earlier, Section 102, I.R.C., 1939, penalize a corporation which accumulates its earnings and profits *for the purpose of* avoiding ordinary dividend distributions to shareholders.[1] The constitutionality of this penalty rests upon Congress' legitimate "incidental power to defeat obstruction to that incidence of taxes which it chooses to impose" *Helvering v. National Grocery Co.*, 304 U.S. 282, 286-7 (1938). The penalty is, therefore, not a revenue producing measure, but rather a deterrent to tax avoidance. It is designed as a "prod" to compel the distribution of those corporate profits which are not needed for the continuance of the company's business. *Helvering v. Chicago Stock Yard Co.*, 318 U.S. 693 (1943).

[1] Section 102, I.R.C., 1939, refers to "preventing the imposition of the surtax upon its shareholders"; Section 531, I.R.C., 1954 employs the phrase "avoiding the income tax with respect to its shareholders * * *". The case at bar falls under the 1939 Code.

The fair administration of the revenue laws is involved here. The decision below has opened the door to application of the "improper accumulation penalty" in a manner never intended by Congress and not permitted by the Code. The result will be the automatic power to subject every corporation which is in liquidation over the end of its taxable year to this penalty. This must follow because a corporation which adopts a plan of liquidation will have no "reasonable business need" for accumulating earnings since, according to the Tax Court's reasoning, of necessity it will have restricted or terminated its active business. However, at the same time, the corporation may not properly distribute dividends until known creditors of the corporation have been amply provided for, whether for contingent or fixed liabilities. *Eg.* Ohio Rev. Code, Art. 1701.33; *Snyder v. Nathan*, 353 F.2d 3 (7th Cir., 1965); Annot., 88 A.L.R. 1301. Therefore, if a year-end passes before liquidation is completed, it will be presumed to have the "purpose" proscribed by §531, notwithstanding its actual corporate intention to distribute all corporate earnings to shareholders. (§533(a)).

The lower Courts tend now to apply this penalty solely on the basis of mathematical formulae applied to accumulations without reference to the "purpose" prohibited by that penalty. In the case of a liquidating corporation, this method is improper. Where distributions to shareholders would be at capital gains rates in any event, it is an absolute

fact that the particular purpose proscribed by §102 cannot be present.[2]

There is no authority, prior to this case, which would support the application of this penalty to a corporation in a bona fide state of liquidation.[3] If the rule applied in the instant case were proper, no liquidation could be carried over year's end without *prima facie* liability for this penalty. The Tax Court found as fact that Petitioner had embarked upon a plan of liquidation pursuant to Mr. Turnbull's specific direction and that it had commenced this program. Once a corporation embarks upon a plan of liquidation, distributions thereafter made by the corporation out of non-recurring income should be deemed distributions in liquidation subject to capital gains taxation only. *Hellmich v. Hellman*, 276 U.S. 233 (1944). The penalty is not a "prod" to require corporate distributions of assets other than those relating to current year's earnings and profits. The penalty is imposed only for tax motivated refusal to distribute the cur-

[2] "Preventing the imposition of the *surtax* upon it shareholders * * *" would be impossible because no *surtax* applied on capital gain distributions. §115(c)(2), I.R.C., 1939. *Surtax* was imposed only on ordinary income dividends. §12, I.R.C., 1939. Therefore, it was not within the corporation's power to prevent or create "surtax" after adopting an intention to liquidate.

[3] The only other cases which remotely consider this situation are *Egan, Inc. v. Comm'r*, 236 F. 2d 343 (8th Cir. 1956) and *Eastern R. and Lumber Co.*, 12 T.C. 869 (1949). Both of these cases involved corporations which had terminated one business and were actively searching for another. The prospect of actual liquidation was not involved; rather, both corporations claimed relief from the accumulations penalty on the ground that they needed money to engage in some undetermined future business activity.

rent year's earnings and is measured by the current year's earnings only. (§102(d); §535).

Under normal circumstances, a corporation's right to accumulate earnings to meet its wholly contingent liabilities may be properly limited by the ultimate reality of those obligations as demonstrated by hindsight; but the status of a corporation which has terminated its active business is sufficiently different to require a different rule. A corporation which cannot anticipate future earnings from the continuation of its business must, nevertheless, maintain its liquidity to meet all of its claims; therefore, being in the business of marshalling its assets, it has different "reasonable business needs". After April 1, 1953, Petitioner was no longer a corporation in the business of providing engineering services; it was in the business of liquidating. As a co-defendant in filed lawsuits, it was obligated to accumulate reserves against any risk of loss. Certainly, it was required to anticipate and provide for the income tax liability which immutably accrued on its 1953 income.

If the decision of this case is allowed to stand, it will create a problem of substantial and recurring consequence by supporting the imposition of this penalty on a basis subject only to the whim and patience of the Commissioner. This application of the improper accumulation penalty to liquidating corporations should be considered and reversed.

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this Petition for a Writ of Certiorari should be granted.

WENTWORTH T. DURANT,
3434 First National Bank Building,
Dallas, Texas,
Counsel for Petitioner.

RONALD M. MANKOFF,
3434 First National Bank Building,
Dallas, Texas,
Counsel for Petitioner.

June ....., 1967

CERTIFICATE OF SERVICE

The undersigned certifies that services that service of this Petition has been made on counsel for Respondent and the Solicitor General by deposit in the United States Mail, duly addressed, with proper air mail postage attached.
June ...., 1967

WENTWORTH T. DURANT